

# ANALYSIS OF AMENDED BILL

## Franchise Tax Board

Author: Peace Analyst: John Pavalasky Bill Number: SB 30

Related Bills: \_\_\_\_\_ Telephone: 845-4335 Date Amended: 1/27/99

Attorney: Doug Bramhall Sponsor: \_\_\_\_\_

**SUBJECT:** Qualified Small Business Stock

### SUMMARY

Under the Personal Income Tax Law, this bill would (1) remove the sunset date on the issuance of qualified small business stock, and (2) make legislative findings and declarations relating to the double taxation of corporate dividends and require the Franchise Tax Board (FTB) and the Department of Finance (DOF) to jointly prepare and make recommendations to the Legislature no later than July 1, 2000, with respect to statutory changes aimed at ending or ameliorating the effects of the double taxation of corporate dividends.

In addition, this bill would modify the General Fund revenue forecast calculated by the Department of Finance (DOF) by providing that the revenue reduction from extending the sunset date for the issuance of qualified small business stock would not impact the trigger that would initiate additional reductions in the motor vehicle license fee. This analysis will not address the bill's changes to General Fund revenue forecasts, as this provision does not impact the Franchise Tax Board.

### EFFECTIVE DATE

As a tax levy, this bill would be effective upon enactment and operative for taxable years beginning on or after January 1, 1999.

### LEGISLATIVE HISTORY

SB 671 (Ch. 881, Stats. 1993), SB 1805 (Ch. 1243, Stats. 1994), SB 715 (Ch. 952, Stats. 1996)

### SPECIFIC FINDINGS

#### 1. Small Business Stock

Under both federal and California law, noncorporate investors may exclude 50% of the gain realized and recognized on the sale or exchange of qualified small business stock which has been held for more than five years. The amount that a taxpayer may exclude as gain with respect to qualified small business stock issued by the same issuer is limited to \$10 million (\$5 million for married individuals filing separate returns) or 10 times the taxpayer's original basis in the stock of the issuing corporation.

#### Board Position:

<u>      </u> S	<u>      </u> NA	<u>      </u> NP
<u>      </u> SA	<u>      </u> O	<u>      </u> NAR
<u>      </u> N	<u>      </u> OUA	<u>  X  </u> PENDING

#### Department Director

#### Date

**Gerald Goldberg**

**2/18/99**

To qualify as small business stock for federal purposes, the stock must be that of a "C" corporation whose total gross assets (treating all members of the same parent-subsidary controlled group as one corporation) at all times after August 10, 1993, and before the date of issuance, as well as immediately after the date of issuance, do not exceed \$50 million. The corporation also must meet certain reporting requirements. In addition, during substantially all of the taxpayer's holding period for the stock, the corporation issuing the stock (other than certain excluded corporations) must meet an active business test. Also, the taxpayer claiming the exclusion must have acquired the stock at its original issuance for money or other property (not including stock) or as compensation for services provided to the corporation.

In order to qualify as California qualified small business stock, however, the issuer must meet the following additional rules:

1. Have issued the stock before January 1, 1999;
2. Be doing business in California at all times on or after July 1, 1993;
3. Before the issuance of the stock must have assets of \$50 million or less when measured as a controlled group using modified federal rules; and
4. Must have at least 80% of the total dollar value of its payroll attributable to employment located in California.

For both federal and California purposes, one half of the amount of gain excluded is treated as a preference item under the alternative minimum tax (AMT).

**This bill** would remove the California law sunset date of January 1, 1999, on the issuance of qualified small business stock.

One half of the amount of gain excluded under this provision would continue to be treated as a preference item under the alternative minimum tax (AMT).

## 2. Double Taxation of Corporate Dividends

Double taxation of corporate dividends means the taxation of corporate earnings in the year earned by the corporation and the taxation of the dividend to the recipient in the year that the dividend is received, as follows:

### First Level - Corporate Earnings

Under federal law, the net income of domestic corporations, other than "S" corporations, is taxed to the corporation while foreign corporations are taxed on the net income of the corporation effectively connected with business conducted within the United States. Special rules are provided under Subpart F of the Internal Revenue Code to currently tax the earnings of certain foreign corporations that are controlled by domestic persons rather than to tax those earnings only when distributed as dividends by the controlled foreign corporation (CFC).

Under California law, for corporations (including banks) doing business in California and thus subject to the corporate franchise tax, the net income for the current year (called the "income year") is used to determine the tax imposed for the privilege of doing business in the following year (called the "tax year"). For corporations that conduct business both within and outside of California, the formulary apportionment method is used to determine the portion of the corporation's total worldwide business income attributable to California sources and thus, subject to California franchise tax. Formulary apportionment is a method whereby the weighted ratio that California property, payroll and sales bears to worldwide property, payroll and sales is multiplied by worldwide business income (California currently uses a four-factor formula with sales being double-weighted, although certain taxpayers are entitled to use an equally-weighted three-factor formula). The business income apportioned to California is then added to any nonbusiness income of the corporation derived from a California source to arrive at the net income of the corporation subject to the California franchise tax.

Special rules allow certain corporations to elect by contract to be taxed on the "water's-edge" basis. Under these rules the income earned by the corporation in foreign countries is excluded from the business income base subject to formulary apportionment, while any Subpart F income and CFC income reported for federal purposes is added to the apportionable business income base. In addition, the denominator of the weighted ratio used in the formulary apportionment method is modified to include only property, payroll and sales within the "water's-edge."

#### Second Level - Dividends

Under both federal and California law, distributions from corporations that have sufficient earnings and profits to classify the distribution as a dividend are taxed to the recipient whether that recipient is a corporation or an individual.

Under both federal and California law, if the recipient is a corporation, that recipient is allowed a deduction for a portion of the dividends received. Under federal law, specific rules apply to dividends paid between members of a controlled group of corporations filing a consolidated return to allow a 100% deduction to the recipient corporation for federal purposes. Similarly, under California law special rules are provided to eliminate dividends among members of a unitary group of corporations doing business in California from the calculation of apportionable world-wide or "water's-edge" business income. These special rules are designed to prevent the double taxation of corporate earnings at the corporate level of taxation. Federal law also allows a credit to the recipient of a dividend received from a corporation subject to tax in a foreign country for taxes paid to that foreign country on the corporate earnings.

**This bill** would state that the Legislature finds and declares that (1) the current system of corporate and individual income taxation results in the double taxation of corporate dividends, an inequity that should be addressed, and (2) any changes to address the double taxation of corporate dividends will necessarily be complicated and require study.

This bill would require the FTB and the DOF to jointly prepare and make recommendations to the Legislature no later than July 1, 2000, with respect to statutory changes aimed at ending or ameliorating the effects of the double taxation of corporate dividends.

These recommendations for changes in the law would be required to conform to all of the following principles:

- (1) Any change should be revenue neutral.
- (2) Any change should be consistent with California's history of maintaining a progressive personal income tax structure.
- (3) Any change should be consistent with healthy economic growth.
- (4) No change should discriminate between those taxpayers who reside within or are located in California and those taxpayers who do not reside in or are located outside of California.
- (5) Any change should ensure that those who actually pay dividends will be benefited thereby and should include any necessary conforming changes to methods of dividend taxation.
- (6) Any change should be made only after considering the effect of that change on unitary entities, S corporations, and other specific classes of taxpayers.

#### Implementation Considerations

Implementing this proposal would not significantly affect the department's programs and operations.

#### LEGISLATIVELY MANDATED REPORTS

This bill would require a report to the Legislature no later than July 1, 2000, with respect to statutory changes aimed at ending or ameliorating the effects of the double taxation of corporate dividends.

#### FISCAL IMPACT

##### Departmental Costs

This bill would not significantly impact the department's costs.

##### Tax Revenue Estimate

The revenue impact of this bill is estimated to be as shown in the following table:

Revenue Impact of SB 30 Amended January 27, 1999 \$ Millions		
2003-4	2004-5	2005-6
\$ (3)	\$ (37)	\$ (44)

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

### Tax Revenue Discussion

The revenue impact of this measure depends on the amount invested in qualified stock, the rate of growth of market value of qualified stock, and the amount of gain realized during the relevant time periods.

The amount invested in qualified stock was estimated from data provided by the Western Association of Venture Capitalists (WAVC) and from academic research (Poterba, National Tax Journal, Vol XLII). The original analysis of the small business stock exclusion (1993) was based on investment data for the period 1991, a recession year. It was assumed that the long-term trend that was exhibited prior to 1988 would resume by 1996. Recent investment data provided by WAVC show that is the case.

It was assumed that half of the qualified firms would survive the first five years. Surviving companies' stock values were approximated using an annual growth rate of 40%. The historical pattern of professional venture capital holding periods was adjusted to take into account behavioral implications of the proposed extension of the exclusion.

The pattern of revenue losses shown in the table reflects the incremental impact of extending the current law sunset date. The current law exclusion is expected to result in increasingly larger revenue losses approaching almost \$50 million by fiscal year 2002-3 and then, due to the sunset date, current law losses are expected to drop to \$17 million in 2004-5 and continue declining thereafter. This bill would result in a resumption of the increasingly larger loss pattern exhibited prior to the sunset date.

For example, the current law exclusion is expected to result in revenue losses of \$17 million for fiscal year 2004-5. If this bill becomes law, the total losses would approach \$54 million for the first full year impact (fiscal year 2004-5) for an incremental revenue loss of \$37 million as shown in the table. Only a partial year impact of a net additional loss of \$3 million is shown for fiscal year 2003-4.

### BOARD POSITION

Pending.